Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Hollingsworth | Analyst: Darrine Distefano | Bill Number: SB 4

Related Bills: See Legislative History | Telephone: 845-6458 | Introduced Date: December 2, 2002

Attorney: Patrick Kusiak | Sponsor:

SUBJECT: PIT Rates/Reduce All Marginal Tax Rates Beginning On or After January 1, 2003 & Eliminate Alternative Minimum Tax Beginning On or After January 1, 2007

SUMMARY

This bill would:

- reduce all personal income tax (PIT) rates over a five-year period to zero,
- eliminate the alternative minimum tax (AMT) by January 1, 2007, and
- modify how nonresidents and part-year residents are taxed.

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to alleviate the tax burden for all taxpayers.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and apply to taxable years beginning on or after January 1, 2003.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Federal law imposes five different income tax rates on individuals ranging from 15% to 39.6%. Existing state law imposes six different PIT tax rates ranging from 1% to 9.3%. Each tax rate applies to a different level of income and is also known as a "tax bracket."

Existing federal and state laws provide for an alternative minimum tax liability, which ensures that taxpayers with substantial economic income and credits, deductions, and other preference items do not completely escape taxation. Federal law provides a personal income AMT rate of 26%, and the state provides a personal income AMT rate of 7%.

Current state law requires the Franchise Tax Board (FTB) to index the tax brackets and the AMT exemption amounts each year to account for inflation.

Board Position:			Department Director	Date
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AB 1115 (Ch. 920, Stat. 2001) modified state law to require nonresidents and part-year residents to compute the rate of tax to be applied to the tax base (California sourced income and deductions of the nonresident or part-year resident), as if:

- the nonresident or part-year resident were a resident of this state for the taxable year; and
- as if the nonresident or part-year resident were a resident of this state for all prior taxable years for any carryover items, deferred income, suspended losses, or suspended deductions.

This means that nonresidents or part-year residents calculate their tax rate by determining the tax on their entire taxable income in the same manner as residents and then by dividing that tax by the income that the tax is calculated upon. That rate is then applied to a base consisting of California sourced income and deductions.

The current law for net operating loss (NOL) deduction allowed in computing the taxable income of a nonresident or part-year resident no longer limits the amount of NOL allowed in computing the "amount of total taxable income" but is a separate computation.

THIS BILL

Beginning with the 2003 taxable year, this bill would incrementally reduce all PIT rates to zero by January 1, 2007. This bill would effectively eliminate PIT.

The PIT tax rates proposed by this bill are in the following table:

PIT Tax Rates					
Current (2002)	*2003*	*2004*	*2005*	*2006*	*2007*
1%	0.80%	0.60%	0.40%	0.20%	0%
2%	1.6%	1.2%	0.80%	0.40%	0%
4%	3.2%	2.4%	1.6%	0.80%	0%
6%	4.8%	3.6%	2.4%	1.2%	0%
8%	6.4%	4.8%	3.2%	1.6%	0%
9.3%	7.54%	5.58%	3.72%	1.86%	0%

This bill would apply to individuals, both residents and nonresidents, sole proprietorships, estates, and trusts.

This bill would repeal the AMT chapter of the Revenue and Taxation Code (R&TC) as of January 1, 2007.

This bill would delete the current rules used by nonresidents and part-year residents for calculating the rate of tax based on income sources. This bill would provide that the amount of tax imposed on a nonresident or part-year resident of California would be computed upon the total income of the individual, as if that individual were a resident of California for the entire year. The resulting amount of tax would be prorated based upon the ratio of adjusted gross income (AGI) with a source in California over AGI from all sources.

Also, this bill would eliminate the current method of determining carryover items, deferred deductions, deferred income, and itemized deductions for nonresidents and part-year residents.

IMPLEMENTATION CONSIDERATIONS

Reducing the PIT rate would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update. However, the rate reduction would result in the elimination of many of the PIT programs within FTB by 2007. This would reduce a large amount of FTB's workload and the revenue generated for the General Fund.

The author's staff has indicated the changes made by this bill regarding the calculation of tax and other items for nonresidents and part-year residents were not intended. However, until the bill is amended the following implementation concern applies:

Current law provides a specific method to determine carryover amounts, deductions, and deferrals of income for nonresidents and part-year residents. This bill would eliminate that method and does not specify how the computation for these complex computations would be made.

TECHNICAL CONSIDERATIONS

The majority of the Personal Income Tax Laws (PITL), certain articles pertaining to personal income tax in the Administration of the Franchise and Income Tax Laws, and the Taxpayer Bill of Rights would need to be repealed or amended to reflect the elimination of the PIT tax rates by the year 2007.

The corresponding sections relating to the calculation of tax within the R&TC for nonresidents and part-year residents would need to be amended to maintain consistency.

Department staff is available to assist with these amendments.

LEGISLATIVE HISTORY

AB 17 (Hollingsworth, 2001/2002) would have reduced all existing PIT rates over a five-year period to zero so that income tax for all individuals would have been eliminated by the year 2005. This bill would have also eliminated AMT in the year 2005. This bill failed to pass out of the house of origin.

AB 1224 (Rod Pacheco, 2001/2002) would have eliminated the lowest PIT rate bracket of 1% for all PIT taxpayers. It also would decrease all remaining PIT tax rate brackets by the year 2003. This bill failed to pass out of the first house by January 31 of the second year of the session.

AB 1115 (Stat. 2001, Chap 920) provides nonresidents and part-year residents clear, definitive rules for calculating loss carryovers, deferred deductions, and deferred income.

AB 4 (Chan, 2003/04) expresses the intent of the Legislature to restore the 10 and 11 percent personal income tax rates for taxable years beginning on or after January 1, 2003. This bill is currently in the Assembly.

OTHER STATES' INFORMATION

Florida does not have a personal income tax. *Illinois* has a flat tax rate of 3%. *Massachusetts* has a split rate, a flat tax rate of 5.3% for most income and 12% for certain capital gains, dividends, and interest. *Michigan* has a flat tax rate of 4.1%. *Minnesota* has a progressive rate with a maximum rate of 7.85%. *New York* has a progressive rate with a maximum rate of 6.85%. All these rates are for the 2002 tax year. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

FISCAL IMPACT

Initially, this bill would not significantly impact the department's costs, as the same number of taxpayers would still be filing returns. Eventual elimination of the PIT programs would result in substantial cost savings for the department's budget. However, the department would still administer the AMT until 2007, the refundable Child and Dependent Care Credit under the PITL, the Homeowner's and Renter's Assistance Program, the Corporate Tax, the various non-tax debt collection programs, which includes child support.

ECONOMIC IMPACT

Revenue Estimate

Based on the data and assumptions below, revenue effects are as follows:

SB 4 Estimated Revenue Impact Enactment Assumed After June 30, 2003 Years Beginning on or After January 1, 2003 ($ Billions)				
Fiscal Year	2003-04	2004-05	2005-06	2006-07
Personal Income Tax Rate Reductions	-11.1	-12.6	-15.4	-26.6
Nonresident Tax Rate	Unknown	Unknown	Unknown	Unknown

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

The above estimates are based on the department's current personal income tax model, expressed to the nearest million dollars. These estimates incorporate the elimination of the AMT rate in 2007, resulting in a sharp loss in the 2006-07 fiscal year. Estimates should be considered preliminary because an updated personal income tax model will be available in one to two months.

The nonresident and part-year resident reversion to prior law determinants of taxable income (pre-AB 1115 of 2002) is unknown.

ARGUMENTS/POLICY CONCERNS

This bill would reduce the regular tax rates incrementally over four years. As a result, there would be an increased number of taxpayers who would owe AMT between 2003-2007 because tentative minimum tax (TMT) would not decrease simultaneously with the regular tax rates therefore creating AMT.

Income taxes for sole proprietorships would be reduced and eventually eliminated by this bill. However, C and S corporations, partnerships, and limited liability companies, would continue to pay taxes (annual tax, fee, or income or franchise tax) under existing law, thus creating different treatment for businesses based on their entity type.

LEGISLATIVE STAFF CONTACT

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